Court defines “financial interest” and makes other FBAR rulings

In *U.S. v. Horowitz*, a district court ruled on various issues regarding the Report of Foreign Bank and Financial Accounts (FBAR). Its decision, handed down in January, addressed the statute of limitations for assessing FBAR penalties and the definitions of various FBAR terms, including the term “financial interest.”

Under the law

Every U.S. citizen who has a financial interest in, or signature or other authority over, a financial account in a foreign country is required to report the account to the IRS annually. This is done by filing an FBAR. The Secretary of the Treasury may impose a civil monetary penalty on any person who violates this requirement or causes a violation.

The statute of limitations for assessing civil penalties for FBAR violations is six years. It begins to run on the date that the FBAR is due.

Accounts closed and opened

The taxpayers in Horowitz were a married couple who lived in Saudi Arabia for most years between 1984 and 2001. Beginning in 1988, they maintained a Swiss bank account. When they returned to the United States, they didn’t close their Swiss bank account and, by 2008, its balance was almost $2 million.

Toward the end of 2008, the husband closed the account and intended to open a joint account at another Swiss bank. But the bank wouldn’t allow him to do so because his wife was absent. When the husband opened the account, he filled out a “List of Authorized Signatories and Powers of Attorney for Natural Persons,” designating his wife as a person to whom he gave “an unlimited power of attorney.” The form, however, also wasn’t put into effect because his wife was absent. As a result, the husband transferred the money to the account in his name only.

The couple made no additional deposits after opening the second bank account. In 2009, they traveled to Switzerland and added the wife as a joint owner of the account.

Tax filings

The couple’s tax returns, including those for 2007 and 2008, were prepared relying on summaries of information that the husband prepared and mailed to the return preparer each year. These summaries never listed the Swiss accounts. Additionally, the husband, who communicated with the accountants, never asked whether he should disclose either account.

The couple signed their tax returns each year without answering “Yes” to the return question about whether they had money in an overseas account. They also didn’t file an FBAR to disclose either account.

In 2010, they disclosed the funds for the first time. They applied to be accepted into the Treasury Department’s Offshore Voluntary Disclosure Program. They were accepted that same month. As required by the program, the couple filed an FBAR for 2003 through 2008 and amended Form 1040 tax returns for 2003 through 2008. They opted out of the program in December 2012.

In June 2014, the IRS assessed penalties of $247,030 against each of them for their alleged willful failure to disclose the first Swiss account for the 2007 tax year and the same penalties against each of them for their alleged willful failure to disclose the second account for the 2008 tax year.

The husband then filed an FBAR protest, appealing the proposed FBAR penalties to the IRS Office of Appeals. The officer assigned to the case determined that the couple's case should have been in an unassessed posture for purposes of IRS Appeals review. In October 2014, the appeals officer asked an IRS Appeals FBAR coordinator to remove/reverse the FBAR penalties as prematurely assessed. Another Appeals employee then removed the penalty "input date." The IRS brought this action to collect those penalties, and it moved for summary judgment on its claims.

The couple filed a cross-motion for summary judgment, arguing that the IRS had reversed the 2014 penalties, such that the penalties the IRS tried to collect weren't assessed until 2016, when they were untimely.

Insufficient evidence of reversal

The court found that the taxpayers hadn't met their burden of proving that the statute of limitations ran out before the FBAR penalties were assessed. The parties agreed that the IRS timely assessed the FBAR penalties on June 13, 2014, and the statute of limitations for assessing FBAR penalties ran out on December 31, 2015. The issue was whether the penalties could have been and, in fact, were reversed.

The IRS conceded that, around October 24, 2014, the Appeals employee removed the penalty input dates from the modules in her database corresponding to the penalty assessments against the couple. The agency also conceded that she took this action in response to the IRS Appeals FBAR coordinator's request that she remove/reverse the penalties. But the IRS didn't agree that these actions amounted to an actual removal of the penalties themselves.

The court concluded that the couple had provided insufficient evidence that the Appeals employee had reversed the assessment. It also said that the couple hadn't shown that, even if the Appeals employee believed she'd reversed the penalty, she had the authority to do so. Notably, to assess the penalties, the Appeals employee had to not only input the data, but also print a form for her manager to sign. To be able to reverse or remove an FBAR penalty assessment without her manager's signature would be incongruous with his initial signature required to impose the penalty in the first place.

The IRS also noted that an agency must have Department of Justice (DOJ) approval to compromise a government claim that exceeds $100,000. Furthermore, it noted that the penalty section of the Internal Revenue Manual advises IRS employees that postassessed FBAR cases of more than $100,000 can't be compromised by appeals without the DOJ's approval.

Wife not liable for 2008

The court, however, held that the wife wasn't liable for the FBAR penalty with respect to 2008. The IRS argued that the wife had a financial interest in and authority over the second account, based on the couple's intent to include her as an account owner and the husband's designation of his wife as a power of attorney. The wife countered that, despite their intent, she simply wasn't an owner of the second account in 2008 and, because she hadn't provided a signature on the power of attorney form, she didn't have any authority over the account.

Instructions to the 2008 FBAR form provide:

A United States person has a financial interest in ... [a] financial account in a foreign country for which the owner of record or holder of legal title is... a person acting as an agent, nominee, attorney, or in some other capacity on behalf of the U.S. person.

The court said that, when the second bank didn't allow the husband to open the account in both of their names, he took their joint funds and placed them in an account in his name only. Naturally, his wife

couldn't exercise any control of this account without traveling to Switzerland and providing a signature. "Taking money that was in [the wife's] name and placing it in an account that was not in her name cannot, in any light, be seen as acting on her behalf."

Moreover, the court said, the question was whether the husband had acted on her behalf with respect to the account — that is, after the second account existed. The husband made no additional deposits after opening the account. And, there was no evidence that the husband did anything with the account before October 2009, when his wife became a joint account owner.

As to the issue of whether the wife had authority over the account, the taxpayers and IRS disagreed as to what was the definition of "signature or other authority." The IRS argued for an inclusive definition contained in the regulations, which provide the following:

… the authority of an individual (alone or in conjunction with another) to control the disposition of money, funds or other assets held in a financial account by direct communication (whether in writing or otherwise) to the person with whom the financial account is maintained.

Without deciding the issue of which definition should apply, the court said that, even under the IRS's definition, the wife had no authority over the second account in 2008. Without the required signature, she couldn't write to, or otherwise directly communicate with, the bank "to control the disposition of money, funds or other assets." Accordingly, she had no authority over the account in 2008.

Willfulness penalty

The court held that the willfulness penalty applied with respect to both taxpayers for 2007 and with respect to the husband for 2008.

Citing a large series of cases, the court said that willfulness may be proven through inference from conduct meant to conceal or mislead sources of income or other financial information. Willfulness can also be inferred from a conscious effort to avoid learning about reporting requirements. "Willful blindness" may be inferred where "a defendant was subjectively aware of a high probability of the existence of a tax liability, and purposefully avoided learning the facts pointing to such liability."

For 2007 and 2008, Schedule B of Form 1040 provided that taxpayers must complete part III of that schedule if they had either:

- More than $1,500 of taxable interest in ordinary dividends, or
- A foreign account.

The couple had to complete Part III for the "unrelated reason" that they had more than $1,500 in ordinary dividends. A question in that Part asked whether, at any time during the year, the taxpayer had an interest in or signature or other authority over a financial account in a foreign country. It referred taxpayers to the FBAR form. They answered "no" to that question.

The couple testified that, based on conversations with other expatriates living in Saudi Arabia, they believed that income that was earned in Saudi Arabia was subject to tax only there if they banked it overseas. The husband stated that he didn't think he needed to file an FBAR for 2007 or 2008. The wife said she didn't even know what an FBAR was at that time. The couple insisted that neither of them had actual knowledge of the FBAR requirement and, therefore, penalties for willful violations were inappropriate.

The court rejected these arguments.

The couple argued that their friends had told them they didn't need to pay taxes on the interest in foreign accounts. Maybe so, the court said, but there was no information from which the court could assess whether it was reasonable for them to have accepted what their friends told them as legally correct. And, in any event, their friends' views wouldn't override the clear tax return instructions that require a "Yes" answer if the taxpayer has an interest in a foreign account, regardless of whether the funds in it constituted taxable income.

Moreover, the fact that the couple had discussed their tax liabilities for their foreign accounts with friends demonstrated their awareness that the income could be taxable. Their failure to have the same conversation with their accountants "easily" showed a conscious effort to avoid learning about reporting requirements, the court stated. On these facts, willful blindness could be inferred.

Unfortunate outcomes

U.S. taxpayers who live in foreign countries may understandably be confused about whether and how tax law applies to them. This case shows that failing to clarify such confusion through the receipt of competent, professional guidance can lead to unfortunate outcomes in court. Ask your tax advisor for assistance in fully understanding and complying with FBAR requirements. •